BASEL III and BOP/IIP

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Moscow, October 2011

Views expressed are those of the author, not necessarily those of the BIS or of the Basel Committee on Banking Supervision

Basel III objectives

- Strengthening capital base
- Avoid too much leverage
- Improve risk management as well as governance
- Strengthen banks' transparency and disclosures
- Particular focus on the G-SIBs
- 2 main tools: "liquidity" and "capital" standards

1. Global liquidity standards

- 2 minimum standards for funding liquidity:
  - Liquidity coverage ratio (LCR): make sure under a severe stress scenario that banks have high quality and unencumbered liquid assets on a 30 day horizon. *Stock of highly liquid assets/total net cash outflows should be ≥ 100%.*
  - Net Stable Funding Ratio (NSFR): minimum of stable funding sources or maturity structure of both assets and liabilities over a one-year horizon. *Available amount of stable funding (or liabilities) /required amount of stable funding (or assets) should be > 100%.*
- Use of metrics as consistent monitoring tools
  - Contractual maturity mismatch exercise
  - Concentration of wholesale funding, by counterparty, instrument, currency
  - Available unencumbered assets that are marketable as collateral or eligible for central banks' facilities
  - LCR by currency, net of FX hedges
  - Market monitoring tools

Global liquidity standards: transitional arrangements

- LCR will be introduced in January 2015
- NSFR in January 2018
- Both will be subject to an <u>observation period</u> in the interim

2. Capital framework: main goals

- Raise quality and quantity of the regulatory capital base
  - Common equity Tier capital: common shares and retained earnings, no more hybrid capital instruments
  - Transparency of capital base improved
- Reduce procyclicality and promote countercyclical buffers
  - Implement forward looking provisioning (eg expected loss approach)
  - Encourage capital conservation (capital buffers > minimum requirements in case of excess credit growth)
- Enhance risk coverage
  - Raise capital buffers for counterparty credit exposure arising from banks' derivatives, repos and securities financing, with incentives to move OTC business to CCPs
- Supplement the risk-based capital with a leverage ratio
- Addressing systemic risk and interconnectedness, for the G-SIBs (combination of capital surcharges on trading and derivatives activities, contingent capital, bail-in debt, liquidity requirements in case of excessive reliance on short term interbank funding)

More detail on Basel III capital requirements

- Definition of capital ratios
- Risk coverage
- Capital conservation buffer
- Countercyclical buffers
- Leverage ratio

Definition of capital ratios (1)

- Capital surcharges/increases to be fulfilled in 2015: (1) common equity Tier 1: 4.5%; (2) Total Tier 1: 6.0%; (3)Total Tier capital 1 + 2: 8% of risk-weighted assets (RWA)
- Tier 1 = mainly, common shares + retained earnings + common shares issued by consolidated subsidiaries and held by third parties. Dividends are excluded. Not secured, nor covered by a guarantee. Perpetual.
- Tier 2 = o/w instruments issued by subsidiaries and held by third parties. Certain loan loss provisions, against future unidentified losses, limited to 1.25% of RWA. Original maturity > 5 years. Not secured, nor guaranteed.

Transitional arrangements for increased capital (1)

- Banks should meet from 1 January 2013:
  - 3.5% Common equity Tier 1 (4.5% in 2015)
  - 4.5% Tier 1 capital (6.0%)
  - 8.0% total capital (8.0%)
- Phasing in Tier 1 between 2013 and 2015

Risk coverage (2)

- Counterpart credit risk CCR or default risk capital requirements for CCR: using standardized or internal ratings based approach for credit risk,
- Counterparty risk losses: banks must add a capital charge to cover the risk of mark-to-market losses on expected counterparty risk (credit value adjustments: CVA) to OTC derivatives. Transactions with CCPs are excluded.

Capital conservation buffer (3)

- Should be 2.5%, included in Common Equity Tier 1, above the regulatory minimum capital requirement. Minimum capital conservation ratios are set up according to the level of CET1 ratios.
- Should be phased in between Jan 2016 and end 2018. Will increase by 0.625% of RWAs each year up to reach 2.5%.
- Outside of periods of stress banks should hold buffers of capital above the regulatory minimum, through:
  - Reduce distribution of earnings, at the risk of penalties
  - New capital from private sources

Countercyclical buffers (4)

- Will come on top of the *capital conservation buffer* CCB
- Will depend on the assessment made by a national authority
- Will be comprised between 0 and 2.5% of RWAs depending on the judgment of that authority which will announce its decision up to 12 months in advance
- Will be based on the private sector credit exposures geo break of each bank
- Same rates and transitional period as for the CCB

Leverage ratio (5)

- Used to prevent any new built up of leverage in the banking system
- Will be the average monthly ratio of capital/total exposure over a quarter. A minimum of 3% will be tested between Jan 2013 and 2017.
- On-balance sheet items should be net of provisions and valuation adjustments; derivatives should be converted to a loan equivalent amount;
- Off-balance sheet items imply the use of a uniform 100% credit conversion factor.
- Transition period for implementation will start in Jan 2011; minimum ratio of 3% is proposed for an observation period of 4 years. Disclosure of the ratio will start in 2015.

A limited impact on BOP/IIP records …

1. **Impact on BOP/IIP records**

1.1 Capital requirements :

- need of additional resources
  - *through FDI*
  - *More retained earnings*
- *higher capital requirements* for complex securitizations/ resecuritizations /trading book/mark-to-market losses

1.2 Liquidity standards: need of high quality liquid assets

- *Purchases of government debt, domestic and also foreign*
- *Changes in borrowing horizon*

… and even less on BPM6 requirements

2. Other issues related to BPM6 requirements

2.1 Review of the *trading book* by end 2011 and beyond

2.2 *Loan provisioning*: Basel Committee is supporting the IASB initiative to *move to the Expected loss approach* rather than the current Incurred loss one. (Conform to BPM6 7.49)

2.3 Classification of *Hybrid additional Tier 1 capital*: Equity or debt securities?

Basel III requirements do not respond directly to this question which is more of an accounting nature than of a prudential one. Under *BPM6* 5.21, a security should be classified as equity if the holder has a claim on the residual value of the issuer after the claims of all creditors have been met. The security should be assessed to this criterion and classified as equity if it meets it, and classified as debt if it does not.

Thank you